

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Kelley Analyst: Jeani Brent Bill Number: SB 184
Related Bills: See Legislative History Telephone: 845-3410 Introduced Date: 01/14/1999
Attorney: Doug Bramhall Sponsor: Franchise Tax Board

SUBJECT: Apportionment of Business Income/Definition of Extractive Activity

SUMMARY

The bill, sponsored by the Franchise Tax Board, would amend the Bank and Corporation Tax Law to allow top tier corporations of a commonly controlled group, whose members are engaged in an extractive business activity, to elect whether the members of its group would apportion using the single- or double-weighted sales factor.

EFFECTIVE DATE

As a tax levy, this bill would take effect immediately and apply to income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

AB 1040 (Stats. 1997, Ch. 605); SB 715 (Stats. 1996, Ch. 952); SB 1880 (Stats. 1994, Ch. 861); SB 1176 (Stats. 1993, Ch. 946).

PROGRAM HISTORY/BACKGROUND

Prior to 1993, the Bank and Corporation Tax Law (B&CTL) strictly conformed to the Uniform Division of Income for Tax Purposes Act (UDITPA), which provides for the use of an apportionment formula when assigning business income to a state for tax purposes. This formula is the simple average of three factors: property, payroll and sales. Each factor is the ratio of in-state activity to that same activity everywhere. In 1993, the B&CTL was amended to require that the sales factor be double-weighted, thus making the apportionment formula based on four factors. Some taxpayers, however, are still required to use the three-factor formula – those taxpayers that derive more than 50% of their gross business receipts from an extractive or agricultural business. In 1994, the exception to the four-factor formula was expanded to include taxpayers that derive more than 50% of their gross business receipts from savings and loan, banking, or financial business activities.

The requirement for double-weighting the sales factor reflects a determination that sales represents a more significant contribution to a taxpayer's net income than do the other two factors. Incidentally, double-weighting the sales factor shifts some tax burden to companies with large sales in California relative to their investment in property and payroll, thereby reducing the tax burden of corporations that have made substantial investment in property and payroll in California relative to sales.

Board Position:

<u>X</u>	<u>S</u>	<u>NA</u>	<u>NP</u>
<u>SA</u>	<u>O</u>	<u>NAR</u>	
<u>N</u>	<u>OUA</u>	<u>PENDING</u>	

Department Director

Date

Gerald Goldberg

3/9/1999

The following chart illustrates how double-weighting sales may affect taxpayers with the same total factors, but different amounts of sales in California.

Scenario A			Calculation	% of Income Taxable in CA
Factor	CA	Total		
Sales	10	1,000	3-Factor: $\frac{.01 + .10 + .10}{3}$	= 7%
Payroll	100	1,000		
Property	100	1,000	4-Factor: $\frac{.01 + .01 + .10 + .10}{4}$	= 5 1/2%

Scenario B			Calculation	% of Income Taxable in CA
Factor	CA	Total		
Sales	100	1,000	3-Factor: $\frac{.10 + .10 + .10}{3}$	= 10%
Payroll	100	1,000		
Property	100	1,000	4-Factor: $\frac{.10 + .10 + .10 + .10}{4}$	= 10%

Scenario C			Calculation	% of Income Taxable in CA
Factor	CA	Total		
Sales	1,000	1,000	3-Factor: $\frac{1.00 + .10 + .10}{3}$	= 40%
Payroll	100	1,000		
Property	100	1,000	4-Factor: $\frac{1.00 + 1.00 + .10 + .10}{4}$	= 55%

When the apportionment formula was modified to require a double-weighted sales factor, a segment of taxpayers engaged in extractive and agricultural business were adversely impacted and objected. To resolve this issue, the amendment provided an exception to the general rule so that certain taxpayers would not be required to use the double-weighted factor. However, the statute did not allow taxpayers to determine whether their particular situation was harmed or benefited by double or single weighting; rather, the statute specifically provided under which situations taxpayers would be required to use the single-weighted sales factor and required all other taxpayers to use the double-weighted factor. The statute was amended a second time to add banks, savings and loans, and financial institutions to the list of activities which were required to use a single weighted sales factor. Although some taxpayers in the extractive business are benefited by single weighting the sales factor, others are adversely affected. The later assert that they should be allowed to double weight the sales factor as would any other manufacturer.

SPECIFIC FINDINGS

Existing state law provides for the use of an apportionment formula when assigning business income of a multistate or multinational business to California for tax purposes. The general rule, applicable to most corporations, requires a formula that is the average of property, payroll, and double-weighted sales.

The factors are then divided by 4. Each factor is the ratio of in-state activity to that same activity everywhere. The calculation is:

$$\frac{(\text{CA Sales})}{(\text{All Sales})} + \frac{(\text{CA Sales})}{(\text{All Sales})} + \frac{(\text{CA property})}{(\text{All property})} + \frac{(\text{CA payroll})}{(\text{All payroll})} = \frac{\text{California}}{4} \text{ apportionment percentage}$$

For corporations in agricultural, extractive, savings and loan, and banking and financial business activities, the apportionment formula is the average of three factors – the sales factor is single-weighted. The basic calculation is:

$$\frac{(\text{CA Sales})}{(\text{All Sales})} + \frac{(\text{CA property})}{(\text{All property})} + \frac{(\text{CA payroll})}{(\text{All payroll})} = \frac{\text{California}}{3} \text{ apportionment percentage}$$

Property represents the capital investment in the business by the participants, payroll represents the contributions of labor to the earning of income, and sales represents market contributions. Sales generally are assigned on a destination basis. Sales to either jurisdictions where the taxpayer is not taxable or the United States government are "thrown back" to the place of origin. For financial institutions, such as banks and savings and loans, the sales factor primarily consists of interest income received from loan payments.

California business income is multiplied by the apportionment percentage to determine the appropriate income assigned to the taxing jurisdiction.

The bill would amend existing law to allow only top tier corporations of commonly controlled groups to elect whether the members of its group would apportion using the single- or double-weighted sales factor. In order to qualify for the election, the commonly controlled group must be an extractive apportioning trade or business, deriving more than 50% of its gross business receipts from activities relating to the production, refining, or processing of oil, natural gas, or mineral ore.

This bill would require that any top tier corporation so electing would be bound to that election for no less than seven years, thereby ensuring that the election could not be used simply as a means of creative tax planning. This bill would establish various rules, including that a single corporation may make the election, the election must last 84 months, must be made by all top tier members of a group, and may be terminated only for good cause. The bill also would provide rules regarding treatment of members that leave or join the electing group or reorganizations within the group.

Policy Considerations

Although the creation of the extractive business activity exception for the double-weighted sales factor was intended to resolve the concerns of some taxpayers that would have been adversely impacted because of their particular combination of property, payroll, and sales factors, that exception adversely affects numerous other extractive businesses.

This bill would further the intent behind the creation of the double-weighted sales factor exception by allowing extractive businesses to elect which method to use, while providing assurances that the election privilege is not overly discretionary.

The effect of this election will be to allow only one segment of the business community (i.e., extractive industries) to elect either single or double weighting. Other industries may seek similar treatment.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions, which could be accomplished during the department's normal annual update.

Technical Considerations

Amendment 1 would correct a typographical error by inserting the word "a."

Amendment 2 would correct an incorrect cross-reference.

Amendment 3 corrects the grammatical structure of the sentence amended.

Amendment 4 clarifies that the prescribed regulations are a discretionary method of identifying appropriate accounting adjustments to address specified events.

REGULATIONS

This bill would provide that the Franchise Tax Board may prescribe regulations that would be necessary or appropriate to administer the act.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

This bill is estimated to impact Bank and Corporation Tax revenues as shown in the following table.

Fiscal Year Cash Flow Income Years Beginning on and After January 1, 1999 \$ Millions		
1999-0	2000-1	2001-02
(\$10)	(\$10)	(\$11)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact for this bill would be determined by the number of top tier corporations that elect double-weighting and the resulting reduction in their apportionment factors and corresponding tax liability reductions.

This estimate was developed using a microsimulation model of tax returns from prior years for affected companies. It was assumed that top tier corporations would elect the formula that results in reduced taxable income for the group.

BOARD POSITION

Support.

The Franchise Tax Board voted at its December 16, 1998, meeting to sponsor this legislation.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 184
As Introduced January 14, 1999

AMENDMENT 1

On page 10, line 3, before "commonly" insert:

a

AMENDMENT 2

On page 5, line 17, strike "25158" and insert:

25128

AMENDMENT 3

On page 5, strike out lines 18 thru 21, and insert:

Provided by this section. If there is more than one top tier corpoation in the commonly controlled group, all top tier corpoations must elect in order for any election to be effective.

AMENDMENT 4

On page 6, line 27, following the word "as", insert:

may be